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SUBJECT: 2008 BUDGET CONTINUES CONSERVATIVE FISCAL POLICY

REFS: A) 07 Sofia 962 B) 07 Sofia 1262

¶1. (U) Summary: Bulgaria's 2008 state budget continues the Socialist-led ruling coalition's tradition of conservative fiscal planning. Targeting realistic revenues and expenditures and GDP growth of six percent, the budget envisions a three percent surplus and introduces a 10 percent flat tax on income, bringing personal income and corporate taxes into alignment. Defense spending will drop to 2.1 percent of GDP (from 2007's 2.55), while the healthcare and education sectors will receive moderate increases. Center-right opposition parties criticized the projected surplus as excessive, while the IMF commended the GOB for its continued fiscal discipline and stressed the need to keep a watchful eye on the growing current account deficit (which reached 20 percent of GDP in 2007) and inflation (which averaged just over 7 percent in 2007). End Summary.

¶2. (U) The Bulgarian parliament passed the 2008 State Budget Act on December 20. The budget envisions BGN 27.2 billion (USD 19.4 billion) in revenues, or 44.1 percent of projected 2008 GDP. Planned tax revenues are in the amount of BGN 22.1 billion (15.8 billion USD), up 21 percent from last year, mainly due to projected improved collection of VAT and excise taxes. Expenditures total BGN 25.4 billion (18.1 billion USD), or 41.1 percent of projected 2008 GDP, including Bulgaria's BGN 660 million (471 million USD) contribution to the EU budget. To rein in expenditures, the government plans to reduce the number of state employees by 12 percent in 2008 (NB: a dramatic drop that will be a real test). As a result of expected higher revenues over expenditures, a surplus of BGN 1.8 billion (1.3 billion USD), or 3 percent of GDP, will be pursued - a fifth consecutive annual budget surplus. In 2008 government agencies will be able to spend their entire budgets. In previous years, ministries were allowed to spend the last 10 percent of their allocations only if the current account deficit stayed under a certain level.

INCOME TAX RATE NOW A FLAT TEN PERCENT

¶3. (U) The 2008 budget implements the decision made by the ruling coalition in summer 2007 to replace the four-bracket progressive income tax with a 10 percent flat rate (Ref A), bringing personal income and corporate taxes into alignment. The Finance Ministry believes the new flat income tax will reduce the number of Bulgarians working in the grey economy, increase household income, and, eventually, contribute to an increase in tax revenues.

INCREASES IN EDUCATION, HEALTHCARE AND PENSION SPENDING

¶4. (U) When presenting the budget draft to parliament, Finance Minister Plamen Oresharski announced that structural reforms in education and healthcare sectors will dominate the ruling coalition's economic agenda in 2008. The new budget allocates BGN 2.6 billion (1.85 billion USD) for education, a 22 percent increase from last year. In October, the socialist-led cabinet of PM Sergei Stanishev agreed to increase teacher salaries, following a teacher

strike that closed schools for a month (Ref B). The healthcare sector -- also plagued by strikes in 2007 -- will receive a 16 percent increase. Both the ruling coalition and the opposition agree that the education and healthcare sectors need to be restructured to allow for more private-sector involvement and higher quality services.

¶5. (U) The government will spend a total of BGN 8.3 billion (6 billion USD) on social policies and subsidized labor programs in ¶2008. Following two hikes in pensions last year, the new average monthly pension will be BGN 184 (131 USD) with another increase planned for July 2008.

DEFENCE SPENDING FALLS; BARELY WITHIN NATO GUIDELINES

¶6. (SBU) The Defense Ministry's budget will increase by 11 percent in absolute terms to BGN 1.1 billion (790 million USD) in 2008. This represents approximately 2.1 percent of GDP, a decline from 2.55 percent in 2007. While these cuts will not put Bulgaria below the NATO-required minimum of two percent of GDP, any further cuts could jeopardize Bulgaria's ongoing military modernization process and MOD support for deployments, since personnel costs for missions such as Iraq and Afghanistan must be paid directly out of MOD coffers. The MOD battled fruitlessly against the reduced budget. The Embassy pushed for retention of a greater percentage, but the Prime Minister's office noted that with a growing economy the Defense Ministry would still have 300-400 million leva more in 2008 than in 2007. The key, according to the PM's office, is sensible MOD restructuring.

COALITION DECIDES NOT TO PUSH TAX BREAKS FOR CASINOS

¶7. (SBU) The ruling three-party coalition discarded originally proposed tax breaks on gambling establishments after leading think tanks and commentators -- spurred to action by public comments made by the Ambassador -- asserted that these breaks were designed to



benefit a handful of individuals with shady ties. Pursuant to this decision, the gambling tax will remain at 10 percent for casinos and 12 percent for all other games of chance.

OPPOSITION CRITICIZES, IMF LAUDS

¶8. (SBU) Opposition leaders criticized the budget for its overly conservative approach. Martin Dimitrov, an MP from the opposition center-right UDF party and a Deputy Chair of the Budget and Finance Committee, argued that authorities were holding back economic growth by targeting a budget surplus as large as three percent of GDP. The leader of the center-right Democrats for Strong Bulgaria (DSB) Ivan Kostov noted that predictions on budget revenues should have been less conservative, and more support should have been given to employees in the healthcare and education sectors. The opposition also criticized as opaque and nontransparent the government's decision to set aside BGN 1.2 billion (860 million USD) as a state guarantee for the new nuclear power plant at Belene (north-central Bulgaria), which will be built by the Gazprom-led company Atomstroyexport.

¶9. (U) Commenting on the budget, the Board of Directors of the IMF praised the GOB for its continued prudent budget policies that have allowed it to accumulate a fiscal reserve of 9 billion leva (6.7 billion USD). At the same time, the Fund urged the GOB to continue fiscal discipline, maintain control of income growth, and spur structural reforms in order to maintain economic stability. The IMF's main concern is the high current account deficit which reached 20 percent of GDP in 2007.

¶10. (SBU) Comment: Apart from the introduction of the flat income tax, the 2008 budget does not depart dramatically from any of its recent predecessors. The government commendably continued fiscal restraint in the face of rising inflation and mounting pressure for wage increases, especially in the healthcare and education sectors. The ruling coalition now has a very limited window to introduce meaningful structural reforms in these and other public sectors to avoid strikes and political marksmanship similar to -- or worse than -- that seen in 2007. The government will require considerable political will to implement these needed, but in many cases

unpopular, structural reforms.  With 2009 parliamentary elections looming, 2008 will be a defining year for economic growth and budget discipline.  End Comment.
KARAGIANNIS